by
Peter Vayanos
peter.vayanos@booz.com
Dr. Philipp Wackerbeck
philipp.wackerbeck@booz.com

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Islamic Banking

How do Islamic banks compete in an increasingly competitive environment

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CONTACT INFORMATION

Beirut
Peter Vayanos
Partner
+961-1-336 433
peter.vayanost@booz.com

Munich
Dr. Philipp Wackerbeck
Associate
+49-89-54525-659
philipp.wackerbeck@booz.com

'ISLAMIC BANKING

How do Islamic banks compete in an increasingly competitive environment'

The market for Islamic banking has grown rapidly over the past few years and is expected to continue to exhibit robust growth for the foreseeable future. In many markets, Islamic banking has evolved from being a niche offering to part of the mainstream financial services landscape.

At the same time, the competitive landscape is being re-drawn with more Islamic financial services institutions than ever before present in the marketplace. Incumbent banks and new market entrants are facing vastly different market conditions and need to develop new sources of differentiation beyond Shari'ah compliance to compete successfully in the future.

This paper seeks to analyze the drivers of growth behind Islamic banking, the changing competitive landscape, potential sources of differentiation for existing Islamic banks, and the challenges that are unique to Islamic banks.

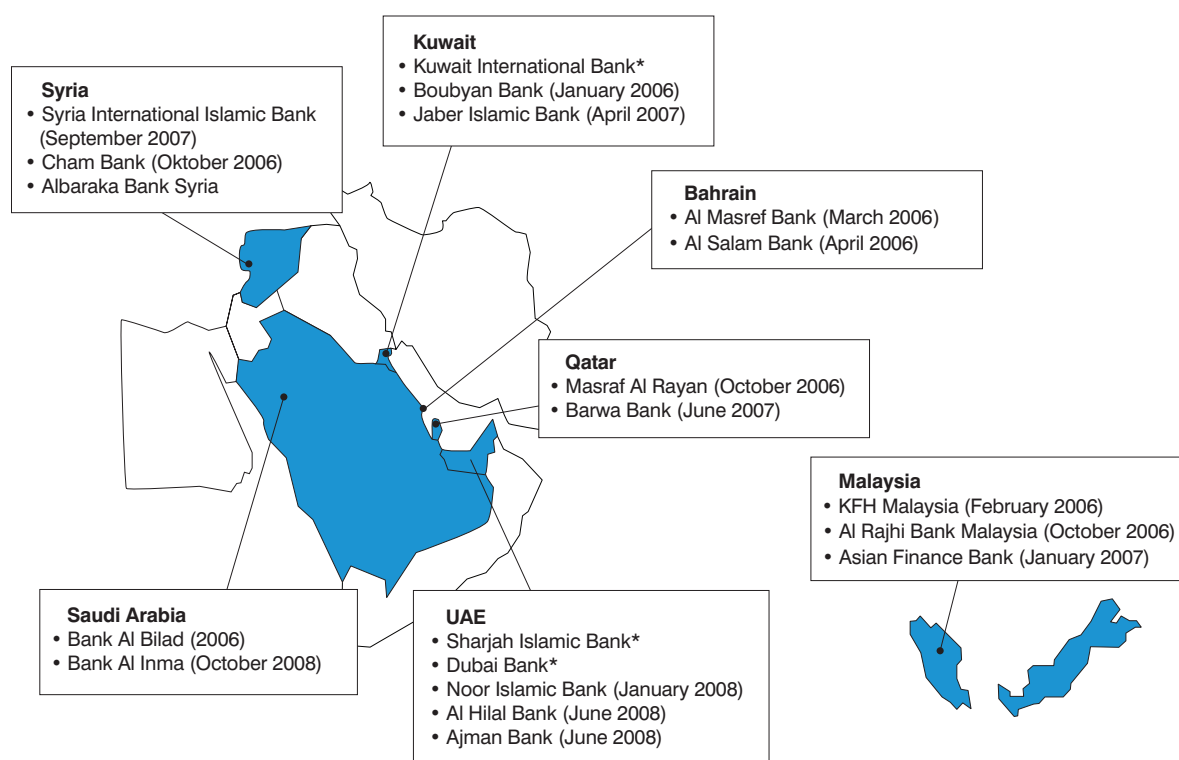
Background to Islamic banking

Since its emergence in the late 1970s, Islamic banking has emerged from being a niche offering to part of the mainstream financial services landscape. Although there are few official statistics on the size of the market and estimates vary widely, the total volume of Islamic assets is believed to be in the region of US$ 500BN.

Dubai Islamic Bank is generally acknowledged to be the first full-fledged Islamic bank. Since its formation in 1975, the number of institutions operating in line with Islamic law (Shari'ah) has mushroomed. Today there are more than 500 Islamic financial services institutions world-wide.

Over the past two to three years alone, more than 50 Islamic financial services institutions have been launched globally. In particular the Middle East has witnessed an explosion in the number of Islamic financial services institutions. For example, Noor Islamic Bank and Al Hilal Bank have been formed in the UAE, Boubyan Bank has been launched in Kuwait, while Al Bilad Bank has been launched in Saudi Arabia, and Al Inma Bank is under formation. The

Exhibit 1:
Examples of new Islamic banks

The penetration of Islamic banking is growing on the back of a number of new institutions in traditional markets.
Selected New Islamic Banks (excluding banks with Islamic windows)

* Conversions of conventional banks to Islamic banks
Source: Central Banks, The Banker, Islamic Business and Finance Network, Islamic Development Bank

total capital of these banks alone is in the region of US$ 7BN. Exhibit 1 shows examples of new market entrants in the GCC and Malaysia.

A GROWING MARKET

Historically, the growth in Islamic banking came mainly from the desire of retail banking customers who were seeking to borrow and invest in accordance with their personal beliefs. This was despite the fact that Islamic banking products were initially not as competitive as their conventional counterparts.

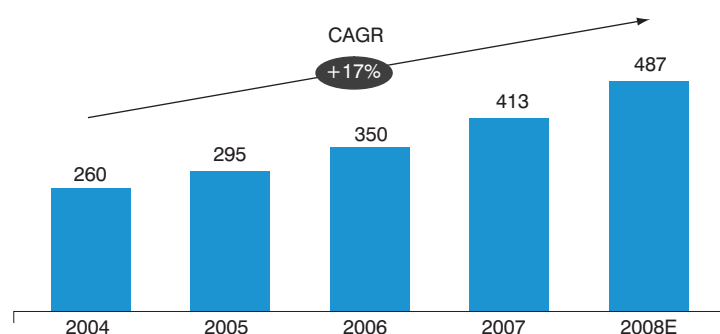
In certain countries, governments fostered the development of the Islamic banking sector. For example, in Malaysia, the Government was the driver behind the development of the sector by funding Islamic financial services institutions and by creating the enabling legal and regulatory frameworks.

Over time the growth in Islamic banking gathered pace. This has mainly been driven by economic and demographic growth in mainly Muslim countries which has spurred the demand for Shari'ah compliant solutions. However, the supply side has also had a role to play; as more financial services institutions offer Islamic banking products, this raises the level of awareness among customers and increases the competitive intensity in the marketplace.

As a result, Islamic assets have grown between 15-20% per annum over the past five years making Islamic banking one of the fastest growing sectors in the global financial services industry. Exhibit 2 charts the growth in Islamic assets over the past 5 years.

The growth in Islamic banking has not been limited to retail and commercial banking alone. On

Exhibit 2:
Growth of the Islamic banking industry

By the end of this year, total volume of Shari'ah compliant assets could reach almost half a trillion USD
Total Volume of Shari'ah Compliant Assets (in BN USD)

Source: Booz & Company Analysis

the asset management side, there has been exponential growth in Shari'ah compliant funds in recent years. Exhibit 3 charts the growth in Islamic equity funds over the past 5 years.

Similarly Islamic capital markets have witnessed a wave of innovation over the past few years. Today, most conventional capital markets products and solutions can be replicated in a Shari'ah compliant manner. The most notable instrument that has emerged has been Sukuk. In the period 2002 – 2007, US$ 85 BN in funds were raised through Sukuk. Exhibit 4 shows the growth in Sukuk since 2002

Future growth a function of both demand and supply factors

We believe that the market for Shari'ah compliant financial services will continue to growth driven by both demand and supply factors.

On the demand side, the desire to conduct all financial transactions in accordance with Shari'ah is expected to further increase – not only among retail customers, but also increasingly among corporations. There is evidence of pressure by the public and shareholders in the Middle East and South East Asia on corporations and sovereigns to apply Shari'ah compliant solutions. This includes, for example, the adoption of Islamic bonds (Sukuk) or Shari'ah compliant syndicated lending based on Murabahah or Ijarah contracts. Interestingly, non-Muslim sovereigns such as the UK, Japan and China have recognized this shift and are preparing Shari'ah compliant debt issues to target the liquidity rich Middle East.

The changing demographics of Muslim countries will also drive the demand for Shari'ah compliant financial services. Many Muslim countries have population growth rates of more than 3% per annum. In addition, many of these countries are characterized by young populations with more than 50% of the population yet to reach adulthood. At the same time, there is evidence of increasing sophistication among youthful consumers regarding their financial services purchases. Hence the twin effects of population growth and increasing sophistication is likely to result in a large number of savvy retail consumers in the near future.

Finally, from the demand side, the overall macroeconomic growth in Muslim countries will drive the growth of Shari'ah compliant financial services.
This is particularly relevant in the oil rich countries of the Gulf where state-owned enterprises which tend to strictly adhere to Shari'ah are the immediate beneficiaries of the booming hydrocarbon prices.

On the supply side, the main driver is the increasing number of financial services institutions offering Shari'ah compliant solutions. In addition to the new Islamic banks that are being formed, there is an emerging trend of existing conventional banks converting their operations to be Shari'ah compliant. For example, National Bank of Sharjah recently converted its entire operations and National Commercial Bank – Saudi Arabia's largest bank – converted its retail operations to be Shari'ah compliant.

The increase in supply has two effects. Firstly, with a greater number of players in the marketplace, the level of awareness of Shari'ah compliant products and services is heightened. This is important since in many countries, including Muslim countries, the level of awareness and understanding of Shari'ah compliant products is remarkably low.

Secondly, a larger number of providers leads to increased competition in the marketplace with improved productinnovation and pricing. This in turn is increasing the attractiveness of Shari'ah compliant solutions to both Muslims and non-Muslims alike.

In conclusion, the market for Islamic banking shows rich potential. The question facing both incumbents and new market entrants is what needs to be done to win in this market.

A CHANGING COMPETITIVE ENVIRONMENT

The competitive landscape and the basis of competition in Islamic banking is changing. Originally, Islamic banks derived their competitive advantage not only because they were Shari'ah compliant, but also because they were the only pure-play Islamic bank in town. For example, Al Rajhi Bank in Saudi Arabia, Kuwait Finance House in Kuwait, and Dubai Islamic Bank in the United Arab Emirates long benefited from monopoly-like status in their respective markets.

This situation has changed considerably over the past few years. For example, in the United Arab Emirates, there are now eight full-fledged Islamic banks and many Islamic windows of conventional banks. Saudi Arabia has three full fledged Islamic banks and all the remaining banks offer Shari'ah compliant solutions through various distribution channels.

The increasing number of players in the marketplace is putting pressure on pricing and eroding margins. At the same time, consumers are increasingly demanding a return on funds deposits with their banks. This is either through direct returns on funds deposited through Mudarabah based profit-and-loss-sharing investment accounts or by switching to investment products such as mutual funds. This has the effect of negating the traditional advantage of Islamic banks on the funding side.

As competition intensifies, the providers of Islamic financial services need to develop sources of differentiation beyond Shari'ah compliance. It is quite possible that the sources of differentiation will need to be different between full-fledged Islamic banks and those banks with Islamic windows.

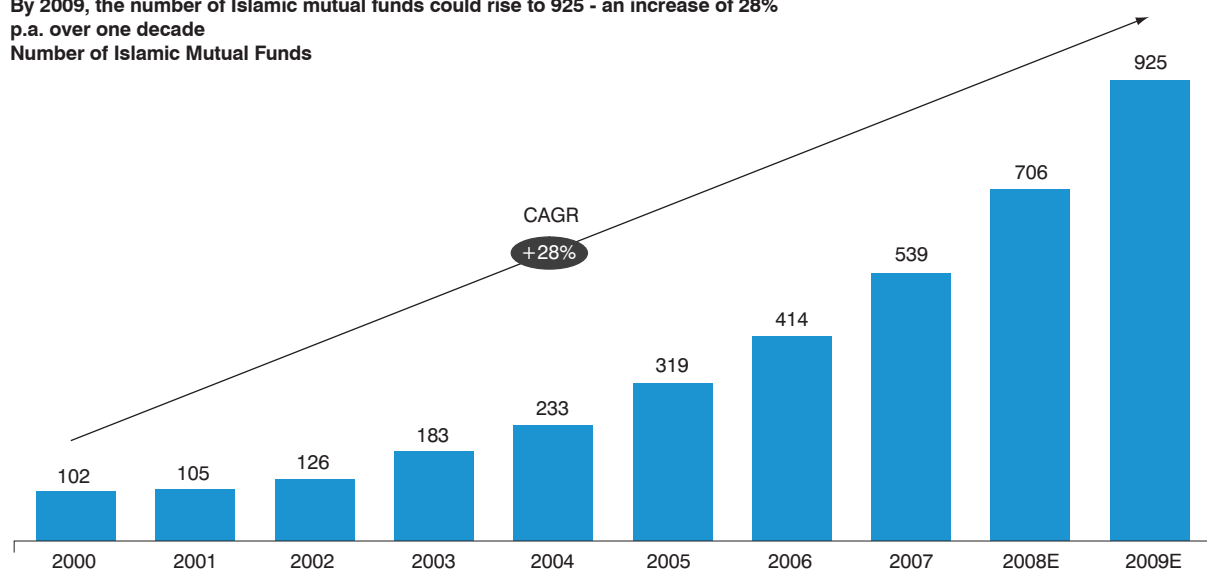
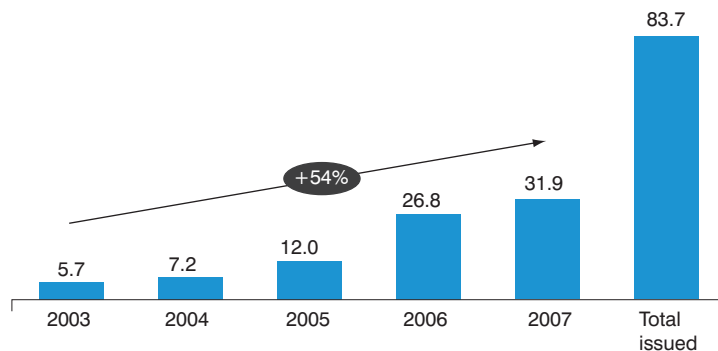
Exhibit 3:
Number of Islamic Mutual Funds

Source: Failaka, Zawya, Booz & Company Analysis

Exhibit 4:
Growth of the Islamic banking industry

The volume of new Sukuk issues has risen to almost 32 BN USD in 2007 – an increase of 54% p.a. since 2003
Total Global Sukuk Issuance (Domestic & International Sukuk – Best Estimate including both Sovereign & Corporate issues) in BN USD

Source: IIFM analysis, IFIS, Booz & Company Analysis

CHANGING THE BASIS OF COMPETITION

In our view, the future sources of differentiation for Islamic banks will likely revolve around three areas:

- Product development and innovation
- Distribution
- Operational excellence

Product development and innovation

Product development in Islamic finance has made significant advances in recent years. Today most conventional products, be it in banking, asset management or capital markets can be replicated in a Shari'ah compliant manner.

Product innovation has emerged not only in response to the increasingly competitive environment, but also to address emerging customer needs. For example, on the retail side, more and more customers are seeking a return for the funds deposited with their banks. Mudarabah based profit-and-loss sharing investment accounts have emerged as a vehicle to address this need. Likewise the need to be able to fund purchases of real estate over long periods of time has led to the development of Islamic mortgages.

The challenge facing Islamic banks from a product perspective is not only to offer products that cover the same scope as conventional banks, but to ensure that these products are differentiated from their Islamic peers. In this regard, having a well-honed product development capability is paramount.

In our opinion, the following key requirements need to be in place to establish a differentiated product development capability:

- Market intelligence process that captures customers
- Robust product development methodology that is able to rapidly develop and deploy
- Mechanism to engage the Shari'ah Board early on to seek approval for the proposed product/
- MIS to track performance and fine-tune the product/ service as required

The above requirements are common to all banks with the exception of the mechanism to secure Shari'ah Board approval. However, it is the latter that often causes the product development process in Islamic banks to be protracted. The absence of universal standards to govern Islamic products only exacerbates this problem.

The solution to the above problem is to have a Shari'ah Board well versed in financial services matters, and a process to seeks to engage the Board early on for preliminary approval. To the extent possible, adopting a set of standards would also measurably improve the product development process.

Distribution

Islamic banking products are inherently more complex than their conventional counterparts. In addition to having to avoid issues around riba (interest), gharar (speculation) and maysir (gambling), Islamic transactions generally involve two legs. This places a burden on distribution which has to a) explain the intricacies of the products to clients, and in some cases convince them of their Shari'ah compliance, and b) the need to engage asset/ commodity providers as part of the transaction.

Not surprisingly the answers to the above problems are straightforward. Leading Islamic banks offer extensive training to their front-line staff. Training needs to cover not only the product features, but also how the transaction is processed. This in turn allows front-line staff to satisfy the increasing proportion of customers who are not satisfied with a simple statement that the product is Shari'ah compliant, but want to understand the underlying features of the product/ service.

On the channel side, a well-established solution is to partner with asset/ commodity providers. For example, Kuwait Finance House operates two auto showrooms where sales representatives of various dealers present new and used cars. When a customer decides to purchase a car, he then arranges the financing with KFH's bankers which are present in the showroom. After completing the assessment of creditworthiness, the bank's Murabahah department purchases the car from the dealer's sales representative and resells it to the customer at a profit. The benefit of this approach, of course, is that the entire transaction takes place under one roof.

Operational excellence

The increasing competitive intensity among Islamic banks is putting pressure on prices. At the same time, the historic advantage of Islamic banks – the non-interest bearing deposit – is coming under threat due to customers' desire to invest in better yielding products. As mentioned above, Islamic banks have inherently more complex operations than their conventional counterparts. All of the above are placing pressures on margins and driving Islamic banks to seek out avenues to improve operational performance. Such performance improvement is even more relevant for Islamic windows as both conventional and Islamic operations are run in parallel – with the respective disadvantageous economics. A major component of operational excellence is a high-performance infrastructure and flexible IT systems allowing for straight-through processing and an industrialized production. Therefore, modular IT solutions are required in which standard components can be individually combined to enable both conventional and Islamic transactions.

CHALLENGES FOR ISLAMIC BANKS

The unique characteristics of Islamic banking give rise to a set of challenges that have to be addressed by Islamic banks. These include:

- Establishing appropriate risk and liquidity management techniques
- Achieving consistent Shari'ah supervision
- Managing the talent pool
- Addressing legal and tax restrictions

Establishing appropriate risk and liquidity management techniques

The risk profiles of Islamic financial institutions differ from their conventional counterparts. The reason lies in the different risk profiles of some of the Islamic financing techniques. For example, in an auto Murabahah transaction, there is the risk that the customer does not purchase the vehicle from the bank even if he gave the commitment to do so. The less standardized the goods financed via Murabahah, the greater the risk. This risk becomes even more relevant in the Mutajarah business in which the bank purchases certain assets/ commodities and holds them as inventory.

As a result, Islamic banks have to revisit their risk management techniques and deploy appropriate capabilities to counter/ mitigate the above risks. The issue is that conventional risk management techniques and instruments are not fully sufficient for all Islamic banks. Especially when an Islamic bank engages in Mutajarah business, risks associated with managing inventory have to be managed and thus cross-industry know-how needs to be transferred, e.g. from retailers, and applied accordingly.

A major challenge facing Islamic banks is the absence of short-term liquidity management and longer-term refinancing instruments. As a result, asset-liability management is becoming a real problem. On the short-term side, Shari'ah compliant money market instruments are in short supply and commodity based reverse Murabahah transactions can only be regarded as an interim solution. A similar issue exists on the long-term financing side where the issuance of Sukuk is the only option available provided an underlying asset exists on which to base the financing.

Achieving consistent Shari'ah supervision

The market for Islamic finance faces one major problem – the absence of universal standards. Geographical differences exist, and even within one country, different Shari'ah Boards may deliver different interpretations. The absence of universal standards, and the lack of transparency regarding the application of Shari'ah places a huge burdens on the marketing of Islamic financial services.

Managing the talent pool

As noted previously, the Islamic banking industry has experienced rapid growth over the past few years, and this growth is expected to continue for the foreseeable future. A major impediment, however, to realizing the future potential of Islamic banking is the limited available talent pool.

At present, there are simply not enough persons with the requisite skills available in the marketplace. This situation exists at all levels within financial services institutions, but is particularly acute at the Shari'ah Board level. It takes many years of education and practical experience to become a Shari'ah scholar. As a consequence there are few scholars available and many scholars sit on multiple boards raising the evitable issue of conflict of interest.

As educational institutions respond to the demand for Islamic finance training courses, the gap between demand and supply will reduce over time. However, in the short-term the lack of skilled resources will likely persist and limit the development of the industry.

Addressing legal and tax restrictions

In many non-Muslim countries, Islamic and conventional banks do not compete on a level playing field. There are numerous legal and tax restrictions which make it difficult for Islamic banks to compete. For example, in many jurisdictions, Islamic real estate financing through the diminishing Musharakah technique leads to a double taxation with conveyance duty on the acquisition of the real estate.

Some countries such as the UK have taken the lead in abolishing legislation that places Islamic finance at a disadvantage. However, unless other countries follow a similar path, it will limit the development of this form of finance.

CONCLUSION

In conclusion, the market for Islamic banking shows rich potential. However, as the competitive intensity increases, the winning players will be those that are able to deploy differentiated capabilities and address the existing challenges unique to Islamic banks.

Peter Vayanos

Peter Vayanos is a Vice President and Partner with the Financial Services Practice of Booz & Company, and is based in the Beirut office. Peter specializes in the development and implementation of transformation strategies for retail banks, private banks, and insurance companies. In this context, he has worked with leading financial institutions in Europe and the Middle East.

Peter holds a Bachelor of Commerce and Bachelor of Commerce Honors degrees from the University of Cape Town, and an MBA from the Massachusetts Institute of Technology Sloan School of Management.

Philipp Wackerbeck

Dr. Philipp Wackerbeck is an Associate with the Financial Services Practice of Booz & Company, and is based in the Munich office. He specializes in the development of growth strategies for financial services companies, particularly with regard to Islamic finance. Philipp has worked with banks, insurance companies and asset managers in Europe and the Middle East.

Philipp is an Associate Fellow of the Institute of Islamic Banking and Insurance in London. He holds a PhD in Economics from the European Business School in Oestrich-Winkel and a Master's degree in Business Administration from the University of Passau.

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